United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

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United States Court of Appeals

For the Second Circuit.

HARRY LEWIS,

Plaintiff-Appellant,

against

GEORGE L. VARNES,

Defendant-Appellee,

and

ELI LILLY AND COMPANY,

Defendant.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK.

BRIEF FOR PLAINTIFF-APPELLANT.

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Statement.

Plaintiff-appellant is appealing from a final judgment entered January 7, 1974 (App. 23a), by order of the United States District Court for the Southern District of New York (Pollack, J.), in accordance with an opinion dated January 4, 1974 (App. 18a), which denied appellant's motion and granted appellee's motion for summary judgment dismissing the complaint. The opinion of the court below is officially reported in 368 F. Supp. 45.

This action was instituted by the appellant, a stockholder of Ely Lilly and Company (hereinafter referred to as "Lilly"), pursuant to the provisions of Section 16(b) of the Securities Exchange Act of 1934, to recover the short-swing profits realized by the appellee from his transactions in Lilly's securities (App. 3a).

The Facts.

All of the material facts have been stipulated to by the parties (App. 9a) and can be summarized as follows:

Appellant, Harry Lewis, is a stockholder of Lilly. Prior to filing his complaint in the court below the appellant requested Lilly to institute such action but it failed and refused to do so (App. 16a; Exhibits V and W).

Lilly is an Indiana corporation. During all relevant times its shares of common stock were registered with and listed on the New York Stock Exchange, a national securities exchange (App. 16a).

Until December 21, 1970, the appellee, George L. Varnes, was a member of various committees of Lilly, including its executive committee. He was also, until his retirement on January 31, 1971, a director of Lilly and Group Vice President of its Domestic Subsidiaries (App. 9a).

On January 20, 1967, Varnes was granted an option by Lilly to acquire 4,000 shares of its common stock at $89.50 per share; on January 19, 1968, he was granted an additional option to acquire 4,000 shares at $103.50 per share; on February 7, 1969, he was granted an additional option to acquire 4,000 shares at $79.08 per share; and on May 18, 1970, he was granted an additional option to acquire 3,000 shares at $87.50 per share (App. 10a; Exhibits A, B, C and D). Under the terms of his option agreements Varnes' right to exercise such options expired two months following his retirement from Lilly's employ (App. 12a).

As the result of a two-for-one stock split on November 26, 1968, Varnes became entitled to acquire under his aforesaid options a total of 23,000 shares of Lilly's common stock, i. e., 8,000 shares at $44.75 per share, 8,000 shares at $51.75 per share, 4,000 shares at $79.08 per share, and 3,000 shares at $87.50 per share (App. 10a).

Some time during 1968 Varnes asked Lilly's general counsel "whether the provisions of Section 16(b) of the Act applied to an ex-director or officer after his retirement," and Varnes thereafter received memoranda in response to his inquiry (App. 11a; Exhibits G, H and I).

In December, 1970, shortly before his retirement as a director and officer of Lilly, Varnes "gave consideration" to his option rights (App. 12a), and on December 22, 1970, he acquired 1,600 shares pursuant thereto (App. 13a).

On January 18, 1971, Varnes attended a meeting of Lilly's Board of Directors, at which time he submitted his resignation as a director and officer of Lilly to become effective on January 31, 1971 (App. 12a).

On February 2, 1971, two days after his retirement, Varnes exercised part of his stock options by acquiring from Lilly 6,400 shares of its stock at $44.75 per share and 8,000 shares at $51.75 per share. The market price of such stock on that date was $100.00 per share. On March 26, 1971, Varnes exercised the remainder of his options by acquiring from Lilly 4,000 shares of its stock at $79.08 per share and 3,000 shares at $87.50 per share. The market price of such stock on this date was $118.00 per share (App. 13a).

On June 3, 1971, Varnes requested the Commission's opinion as to whether his sales of Lilly's shares after June 22, 1971, would be violative of the provisions of Section 16(b) of the Act. By letter dated June 28, 1971, Varnes was advised that the Commission considered "it would be inappropriate * * * to render an opinion in any particular case" and, therefore, suggested that he confer with his attorney and Lilly's counsel concerning this matter (App. 14a; Exhibits N and O).

Subsequent to the Commission's reply Varnes was advised by his attorney that any sales of the Lilly shares subsequent to June 22, 1971, would not come within the purview of Section 16(b) of the Act (App. 14a).

On July 6, 1971, less than six months after his retirement from Lilly's employ, Varnes sold 5,400 shares of Lilly's common stock at $124.50 per share, 400 shares at $124.75 per share and 500 shares at $125.25 per share. The net proceeds realized by him from his aforesaid sales aggregated $781,631.29 (App. 14a; Exhibits P, Q, R, S and T).

Between January 6, 1971 and January 6, 1972, the lowest price at which Lilly's common stock was traded on the New York Stock Exchange was $100 per share (App. 16a).

The district court granted appellee's motion for summary judgment and dismissed the complaint basing its decision on the opinion in *Levy v. Seaton* (S.D.N.Y.), 358 F. Supp. 1. Because of such disposition of the case the court did not pass upon the validity of the Commission's Rule 16b-6 in so far as it affected the extent of recoverable damages (App. 18a).

Issues Presented.

1. Are the short-swing transactions by a retired director and/or officer subject to the operation of Section 16(b) of the Securities Exchange Act where both his purchases and sales of the issuer's shares were effected by him less than six months following his resignation from office, and his acquisitions of such shares resulted from his exercise of options granted to him by the issuer during the time he held his official position?

2. Is Rule 16b-6 a valid exercise of the Commission's rule-making power?

The Statute.

Sections 16(a) and 16(b) of the Securities Exchange Act of 1934, 15 U.S.C., Sections 78p(a) and 78p(b), provide as follows:

> "(a) Every person who is directly or indirectly the beneficial owner of more than 10 per centum of any class of any equity security (other than an exempted security) which is registered pursuant to section 12 of this title, or who is a director or an officer of the issuer of such security, shall file, at the time of the registration of such security on a national security exchange or by the effective date of a registration filed pursuant to section 12(g) of this title, or within ten days after he becomes such beneficial owner, director, or officer, a statement with the Commission, (and, if such security is registered on a national securities exchange, also with the exchange) of the amount of all equity securities of such issuer of which he is the beneficial owner, and within ten days after the close of each calendar month thereafter, if there has been a change in such ownership during such month, shall file with the Commission (and if such security is registered on a national securities exchange, shall also file with the exchange), a statement indicating his ownership at the close of the calendar month and such changes

in his ownership as have occurred during such calendar month.

"(b) For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

The Commission's Rule 16a-1(e).

The Commission's Rule 16a-1(e), 17 CFR 240.16a-1(e), in so far as is here material, provides as follows:

"Any person who has ceased to be a director or officer of an issuer which has equity securities

registered pursuant to Section 12 of the Act, * * * shall file a statement on Form 4 with respect to any change in his beneficial ownership of equity securities of such issuer which shall occur on or after the date on which he ceased to be such director or officer, * * * if such change shall occur within 6 months after any change in his beneficial ownership of such securities prior to such date. * * *."

The Commission's Rule 16b-6.

The Commission's Rule 16b-6, 17 CFR 240.16b-6, in so far as is here material, provides as follows:

> "(a) To the extent specified in paragraph (b) of this rule, the Commission hereby exempts as not comprehended within the purposes of Section 16(b) of the Act any transaction or transactions involving the purchase and sale, or sale and purchase, of any equity security where such purchase is pursuant to the exercise of an option or similar right either (1) acquired more than six months before its exercise, or (2) acquired pursuant to the terms of an employment contract entered into more than six months before its exercise.
>
> "(b) In respect to transactions specified in paragraph (a) the profits inuring to the issuer shall not exceed the difference between the proceeds of sale and the lowest market price of any security of the same class within six months before or after the date of sale. Nothing in this rule shall be deemed to enlarge the amount of profit which would inure to the issuer in the absence of this rule."
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> * * *
>
> "(e) The burden of establishing market price of a security for the purpose of this rule shall rest upon the person claiming the exemption."

POINT I.

The evolution and purpose of Section 16(b) of the Securities Exchange Act of 1934.

The stock market crash of 1929 resulted in widespread demands for investigations to discover its underlying causes and to find measures to prevent future recurrences.

The resultant congressional investigations focused attention upon the many pitfalls which confronted the millions of investors who participated in the ownership of securities in public corporations and were subjected to numerous abuses by "insiders" who violated their fiduciary duties for personal gain. Since most of the public investors used the facilities of national securities exchanges to effect their stock transactions, unless they were afforded the means of obtaining accurate, adequate and timely information to enable them to make intelligent, independent and informed judgments upon exchanges conducted fairly, freely and as open market places, their investment decisions would continue as games of chance.

The Securities Exchange Act of 1934 "is aimed as an entity toward the reform of the security markets by control of speculation and protection of the public against trading based on inside information and other abuses in the market machinery."[1] In recognizing that the primary cause of investor impotence is the "insider's" ability to control his issuer in utter disregard of his fiduciary responsibilities towards those whom he is presumed to represent, the Securities Act of 1934, as a whole, seeks to ensure to the public that the securities

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[1] 46 Yale L. J. 624, 625. See also *Smolowe v. Delendo Corp.*, 36 F. Supp. 790, 791, aff'd (2 C.A.) 136 F. 2d 231, cert. den. 320 U. S. 751.

exchanges shall be maintained as fair, free and open markets by prohibiting pool operations and other similar market manipulations and by thwarting and punishing any abuses in connection therewith.

In enumerating its reasons for the necessity of such legislation the Congress pointed to the need for regulating and controlling "transactions by officers, directors and principal stockholders * * * to insure the maintenance of fair and honest markets in such transactions" because "frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control * * * resulting in sudden and unreasonable fluctuations in the prices."[2]

Sections 16(a) and 16(b) of the Act were passed by Congress following disclosures of numerous instances where "insiders" of public corporations "used their positions of trust and confidence and the confidential information which came to them in such positions to aid them in their market activities * * * and profit by information not available to others."[3]

As first enacted, Sections 16(a) and 16(b) of the Act were made applicable only to directors and officers of *listed* issuers and to 10% stockholders of such corporations. The provisions of these sections, however, were found to be of such great importance for the protection of public investors generally that in 1964 Congress extended its applications to certain *unlisted* issuers as well.[4]

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[2]Section 2 of the Act, 15 U. S. C., Section 78(b).

[3]Senate Report No. 1455, 73d Cong., 2nd Sess. (1934), pages 55-68; see also, *Securities Regulation*, by Loss (1951), pages 561-598.

[4]See Sections 12(g) and 16(a) of the Act, 15 U. S. C., Sections 78L(g) and 78p(a), as amended.

Section 16(a) of the Act imposes a duty upon every director, officer and 10% stockholder of any issuer covered by its provisions to file with the Commission and with the exchange, if any, upon which such issuer's securities are listed, monthly reports of any changes in his beneficial ownership of his issuer's equity securities.

Under Section 16(b) of the Act Congress provided the means of ensuring to the public investor that the information which he is entitled to obtain should not be made useless to him by the manipulations of an issuer's "insider" who has had the opportunity to take full advantage of inside information prior to its public disclosure.

The stated purpose of Section 16(b) is "preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer, by reason of his relationship to the issuer." Under its provisions any "insider" who purchases and sells, or sells and purchases his issuer's equity securities within any period of less than six months is required to pay over to the issuer all profits realized from such transactions. Moreover, when an "insider" effects this type of transaction, the statutory liability to return the profits to the issuer is automatically imposed upon him "irrespective of (his) intention in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months" (see Sec. 16b of the Act).

One of the draftsmen of Section 16(b) testified that its provisions are designed to reach the "insider's" profits "irrespective of any intention or expectation to sell the security within six months" since it is "absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb,

because you cannot undertake the burden to prove that the director intended, at the time he bought, to get out on the short-swing."[5]

In its effect, Section 16(b) of the Act "was but a new approach to the common-law attitude which had long recognized the reasonableness of enforcing a level of conduct upon fiduciaries 'higher than that trodden by the crowd.'"[6] Recovery under this section is generally predicated upon an objective measure of proof rather than upon any showing that the "insider" *actually obtained* confidential information or that he used it for his personal benefit. For, "had Congress intended that only profits from an actual misuse of inside information should be recoverable, it would have been simple enough to say so."[7] Indeed, "if only those persons were liable who could be proved to have a bargaining advantage, the execution of the statute would be so encumbered as to defeat its whole purpose."[8]

It is thus quite clear that Section 16(b) is wholly unconcerned with either the fairness of a routine short-swing transaction or the "insider's" good faith or intentions in effecting it. The statutory purpose is intended *to deter* him from engaging in such a transaction by compelling him to disgorge his profits therefrom.[9] In short, the provisions of this section merely reiterate the application of the time-honored principle that a fiduci-

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[5]Hearings before Senate Committee on Banking and Currency on S. 84, 73d Cong., 1st Sess. (1934), at page 6557.

[6]*Smolowe v. Delendo Corp.* (2 C.A.), 136 F. 2d 231, 236.

[7]*Smolowe v. Delendo Corp., supra,* at page 239.

[8]*Gratz v. Claughton* (2 C.A.), 187 F. 2d 46, 50.

[9]*Stella v. Graham-Paige Motors Corp.* (2 C.A.), 232 F. 2d 299, 302.

ary may engage in no activity which may, by even a remote possibility, involve a conflict of interest between his official duties and his private interests.[10]

The major objective of Section 16(b) was "to discourage if not prevent three classes of persons from making private and gainful use of information acquired by them by virtue of their official relationship to the corporation," and, although it was recognized that such practices "could not be prevented *in toto*," and that even the "six month limitation alone 'let many fish out of the net,'" Congress, nevertheless, "sought to take the profit out of what it considered improper conduct" from at least those transactions effected within a period of less than six months; and notwithstanding the many complaints by "insiders" as to the harshness of this statute, "it is not wholly accurate to characterize the operation of the statute as 'harsh' or 'crushing' without qualification. Its bite is sharp only in the limited area of the transaction it covers, * * * but for the insider who waits six months and one day after purchase to avoid a short-term gain there is no 'bite' at all," thus making "an honest if not honorable man out of the insider in that period."[11]

In their approach and interpretation of this statute the courts have consistently sought to close all possible avenues leading to its evasion so as "to carry out in particular cases the generally expressed legislative policy,"[12] and thus strike down "any means by which insiders, because of their special knowledge of the affairs

[10] *Michaud v. Girod*, 4 How. 503, 559; *Magrueder v. Drury*, 235 U. S. 106; *Pepper v. Litton*, 308 U. S. 295.

[11] *Adler v. Klawans* (2 C.A.), 267 F. 2d 840, 844-845.

[12] *S.E.C. v. C.M. Joinder Leasing Corp.*, 320 U. S. 344, 350-351.

of the corporation or the plans of its board of directors might realize for themselves a 'short-swing' profit, which would be denied the other stockholders or investing public not enjoying such inside information."[13]

POINT II.

The statutory application of Section 16(b) of the Act extends to all transactions effected by those persons who are subject to the reporting requirements under Section 16(a) of the Act.

Sections 16(a) and 16(b) of the Act are complimentary in so far as the statutory application is intended to be extended to transactions effected by a class of persons referred to therein.[14]

The provisions of Section 16(a) mandate the disclosure requirements with respect to stock transactions effected in an issuer's securities by any of its directors, officers or 10% stockholders, thus earmarking the particular class of corporate "insider" who is required to file reports of any changes in his beneficial ownership of his issuer's equity securities.

The obvious purpose of Section 16(a) is to keep the investing public informed of the "insider's" trading in his issuer's securities because such trading may be based upon inside information not yet publicly disclosed, and the proper evaluation of such security transaction may

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[13]*Kogan v. Schulte* (D.C.S.D.N.Y.), 61 F. Supp. 604, 608.

[14]In *Pappas v. Moss* (D.C.N.J. 1966), 257 F. Supp. 345, the court stated (p. 366) that "Section 16(b) must be read in conjunction with Section 16(a) in order to determine who is 'such * * * director' who may be liable under Section 16(b)."

form the basis of an informed investment decision by the public.

Section 16(b) of the Act is the machinery set up in an attempt to thwart an "insider" from profiting by his inside information by requiring him to disgorge any profits which he might realize from any purchase and sale of his issuer's securities within a period of less than six months.

It appears quite clear from the language of Section 16(b) that its provisions are applicable to any short-swing transaction effected by an "insider" who is required to make disclosure of his stock transactions under the provisions of Section 16(a) of the Act. It follows as a logical corollary that where the applicable rules and regulations of the Commission require that a designated class of "insider" comply with the reporting requirements under Section 16(a), any short-swing transaction required to be reported by such "insider" comes within the purview of Section 16(b).

The Commission's Rule 16a-1(e) provides that "Any person who has ceased to be a director or officer of an issuer * * * shall file a statement on Form 4 with respect to any change in his beneficial ownership of equity securities of such issuer which shall occur on or after the date on which he ceased to be such director or officer, * * * if such change shall occur within 6 months after any change in his beneficial ownership of such securities prior to such date."

Since the appellee, Varnes, while he was still a director and officer of Lilly, had acquired 1,600 shares of its stock on *December 22, 1970* (App. 13a, Par. 14), the provisions of Rule 16a-1(e) *required* him to report any changes in his beneficial ownership of the issuer's shares

for a period of six months *thereafter*. Accordingly, when he subsequently acquired 14,400 shares of Lilly's stock on *February 2, 1971,* and an additional 7,000 shares on *March 26, 1971* (App. 13a, Par. 15), Rule 16a-1(e) *obligated* him to file Form 4 reports disclosing these transactions because they were effected "within 6 months after" his December 22, 1970 purchase.

Rule 16a-1(e) is entirely consistent with the legislative purpose of Section 16(b) because the rule was intended to shut off fertile avenues leading to abuse and evasion of the statutory provisions. The possibility of such abuse is especially magnified in cases such as this, where the issuer has granted to its director and officer options to acquire its securities at a stated price with the right to exercise such options during a period of two months following his resignation from office. Were such transactions deemed to be immune from the operation of Section 16(b), the former director and officer could unfairly utilize his inside information to his personal advantage, thus completely evading the purpose and intent of the statute.

In *Feder v. Martin Marietta Corp.* (2 C.A.), 406 F. 2d 260, this court stated as follows (at p. 269):

> "* * * While we do not here determine the effect of Form 4 on the scope of Sect. 16(a), we do point out that the Form 4 reporting requirement here mentioned extends Sect. 16(b) putative liability to the extent of that requirement. Therefore, inasmuch as Form 4, a valid exercise of the SEC's power, has already extended Sect. 16(b) to cover, in part, an ex-director's activities, a less arbitrarily defined reporting requirement for ex-directors is but a logical extension of Sect. 16(b), would be a coverage in line with the congressional aims and would afford greater assurance that the lawmakers' intent will be effectuated. * * *"

We submit that appellee's obligation to report his acquisitions of Lilly's shares after he had ceased to be a director and officer automatically subjected those transactions to the application of Section 16(b).

The record demonstrates that on July 6, 1971, *about three months after* he had effected his last acquisitions of the issuer's shares which were subject to the reporting requirements of Rule 16a-1(e), and only *about five months* after his resignation as a director and officer, the appellee, Varnes, sold 6,300 shares of the issuer's stock at substantially higher prices than the cost of his prior acquisitions (App. 14a, Par. 20; Exhibits P through T).

While it is true that Rule 16a-1(e) did not specifically require the appellee to report his July 6, 1971 sales, since such latter transactions, nevertheless, occurred less than six months after his reportable acquisitions, the purpose of Section 16(b) can only be effectuated if the entire short-swing transactions here involved are held to be subject to the statutory application.

It would seem that similar considerations for applying Section 16(b) to appellee's sales are present here as in the situations where it has been held to be applicable to part of a short-swing transaction effected by a director or officer *before* he assumed such office,[15] or *after* he had resigned from office.[16]

The court below based its decision on a prior holding in *Levy v. Seaton* (S.D.N.Y.), 358 F. Supp. 1, stating that the opinion there "is dispositive of plaintiff's claim herein" (App. 20a).

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[15]*Adler v. Klawans* (2 C.A.), 267 F. 2d 840; see also, *Blau v. Allen* (S.D.N.Y.), 163 F. Supp. 702.

[16]*Feder v. Martin Marietta Corp.* (2 C.A.), 406 F. 2d 260.

We note, however, that in *Levy, supra, unlike* the factual situation here, the court found (pp. 4-5) that *no part* of the former director's short-swing transaction was required to be reported under the Commission's Rule 16a-1(e). We believe that, apart from other considerations here involved, such distinction has an important bearing on the matter here involved.

POINT III.

The appellee, Varnes, was an "insider" of Lilly within the contemplated purpose of Section 16(b) when he effected his short-swing transactions.

The dominant congressional purpose of Section 16(b), as stated in its preamble, was "preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer." *That* was the principal vice sought to be eradicated.

In specifying the three categories of those who clearly have access to inside information, congress at no time evinced any intention of limiting the statutory application only to those persons legally designated as directors or officers, while completely exonerating those who demonstrably fall within that category, and have similar access to and may possibly use inside corporate information to further their personal interests.

Although a literal reading of Section 16(b) may seem to limit its reach to only those short-swing transactions effected by directors and officers during their term in office, the courts have refused to thus limit the application of the statute in situations where such an interpretation would lead to results clearly at variance with the

history and congressional purpose of this legislation. In such latter instances the courts have looked to the history and underlying purposes of the statute, giving it effect "in accordance with its design and purpose, (and) *sacrificing, if necessary the literal meaning in order that the purpose may not fail.*"[17] (Italics supplied.)

Indeed, this court has confirmed that "the judicial tendency * * * has been to interpret Section 16(b) in ways that are most consistent with the legislative purpose, even departing where necessary from the literal statutory language." And such results have been accomplished "through the creation of a legal fiction (where) our courts have managed to remain within the limits of Section 16(b)'s literal language, and yet have expanded the Act's reach."[18]

Thus, for example, in the *Feder* case, *supra,* where the *sale* involved in the former "director's" short-swing transaction was effected *after* it had ceased to be a "director," this court held (at p. 268) that "'a short-swing' sale or purchase by a resigning director must be a transaction 'comprehended within the purpose of' Section 16(b)" because of the possibility that it "could be motivated by insider information." And again in *Colby v. Klune* (2 C.A.), 178 F. 2d 872, in refusing to limit the application of Section 16(b) only to those legally designated directors or officers of the issuer, this court stated (at p. 873) that a statutory insider also "includes *inter alia,* a corporate employee performing important executive duties of such character that he would be likely,

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[17] *Ozawa v. United States*, 260 U. S. 178, 194; see also, *United States v. American Trucking Assns., Inc.*, 310 U. S. 534, 543; *United States v. Public Utilities Commission*, 345 U. S. 295, 315.

[18] *Feder v. Martin Marietta Corp.* (2 C.A.), 406 F. 2d 260, 262.

in discharging these duties, to obtain confidential information about the company's affairs that would aid him if engaged in personal market transactions."

Here the appellee's short-swing transactions involved his acquisitions of shares through the exercise of options previously granted to him by the issuer during the time he was its director and officer and, *solely* because of that fact. While it is true that he did not exercise such options until shortly after he had resigned his offices, his *right* to exercise the options *subsequent* to his resignation, nevertheless, stemmed from the very stock option agreements which granted him such right *while he held such offices*, and, accordingly, his acquisitions of the optioned shares were in a real sense "insider" stock.

Since the prices at which appellee could exercise his options were *fixed* under the option agreements, the same opportunities for speculative abuse of Section 16(b) were present when he exercised the options *subsequent* to his resignation as a director and officer of the issuer as *before*.

Moreover, not only were appellee's short-swing transactions effected by him less than six months after his resignations from the offices he held with the issuer, but *such transactions were consummated even less than six months after he had attended an official meeting of the issuer's Board of Directors* (App. 12a, Par. 11), thus raising the real possibility that he may have obtained inside information which formed the basis for his short-swing transactions.

Inside information does not evaporate from the mind of a director or officer after he resigns his official office. Since the avowed purpose of Section 16(b) is to prevent such insider from making unfair use of his inside in-

formation by deterring him from buying and selling his issuer's securities within a period of less than six months, similar considerations in effectuating the statutory purpose *require* that his short-swing transactions be subject to the operation of the statute in situations where, armed with the same inside information acquired while holding such office, he buys and sells the issuer's shares within a period of less than six months after his resignation.

Such an interpretation of the statutory purpose is especially valid in situations, such as the present one, where the former director's or officer's short-swing transactions involve his acquisitions of the issuer's shares through the exercise of options granted to him *while* he held his official position. Any other construction would open the door to evasion which would effectively defeat the statutory purpose.

The New English Companies Bill introduced in the House of Commons on December 18, 1973, which "contains comprehensive provisions proscribing insider trading," appears to have recognized the considerations pointed out above by providing that the "Insider status terminates *six months after* the relationship which gives rise to such status terminates."[19]

The instant situation is pregnant with the seed for statutory abuse. Its particular facts are not limited to this isolated case because it is common knowledge that large numbers of publicly-held corporations presently require their officers and directors to retire at a stated definitive age. Many of these retired officers or directors hold unexercised options to acquire their issuer's shares

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[19]See article by Professor Martin Lipton entitled "Trading on Inside Information under the New English Companies Bill," New York Law Journal, January 9, 1974, at page 1.

at a fixed price, and the option agreements grant them the right to exercise the options within a short time *following* their retirement.

Were the court to hold a short-swing transaction effected by such retired director or officer less than six months following his retirement to be outside the scope of Section 16(b), such ruling would open a loophole for evasion which would go a long way towards emasculating the legislative purpose and nullifying the salutary effect of the statute.

POINT IV.

Appellee's transactions were not exempted from the operation of Section 16(b) of the Act.

Appellee argued in the court below (a) that the Commission's Rule 16a-10 allegedly exempted his transactions from the operation of Section 16(b) because he was not required to file any Form 4 reports with respect to these transactions, and, (b) that Section 23(a) of the Act allegedly exempted his transactions from the operation of Section 16(b) because he relied in good faith upon the Commission's Rule 16a-10 and upon the advice which he received from his personal counsel and from counsel for the issuer.

Rule 16a-10, 17 CFR 240.16a-10, provides as follows:

> "Any transaction which has been or shall be exempted by the Commission from the requirements of Section 16(a) shall, in so far as it is otherwise subject to the provisions of section 16(b), be likewise exempted from section 16(b)."

Section 23(a) of the Securities Exchange Act, 15 U.S.C., Section 78w(a), in so far as is here material, provides as follows:

> "* * * No provision of this chapter imposing any liability shall apply to any act done or omitted in good faith in connection with any rule or regulation of the Commission * * *, notwithstanding that such rule or regulation may, after such act or omission, be amended or rescinded or be determined by judicial or other authority to be invalid for any reason."

The basis for appellee's first contention was predicated upon the argument that, since the Commission's Rule 16a-1(e) allegedly did not *affirmatively* require him to file Form 4 reports with respect to his stock transactions subsequent to his resignations from office, such omission in the rule was tantamount to an exemption from the reporting requirements under Section 16(a) of the Act.

The fallacy of such argument becomes quite evident, however, when we consider the factual details of appellee's transactions.

As we have heretofore demonstrated (at p. 14), since appellee had acquired 1,600 shares of the issuer's stock on December 22, 1970, while he was still a director and officer, Rule 16a-1(e) *required* him to file a Form 4 statement with respect to any change in his beneficial ownership of the issuer's shares for a period of six months thereafter. Accordingly, when he subsequently acquired the issuer's shares on February 2, 1971, and March 26, 1971, when he was no longer a director or officer, these transactions were *required* to be reported by him under the provisions of Rule 16a-1(e).

While it is true that Rule 16a-1(e) did not affirmatively require the appellee to file a Form 4 statement with respect to his July 6, 1971 *sales* of the issuer's shares, neither did the rule *specifically* exempt him from reporting such transaction.

An exemption from the general statutory application must be express and unambiguous. One who claims such an exemption must establish his right thereto, and the "terms of such an exception to the 'general policy' of the act must be 'strictly construed' against the claimant of its benefit."[20] It would seem quite clear, therefore, that the affirmative obligation imposed upon a former director or officer under Rule 16a-1(e) to file a Form 4 statement of a *particular type of transaction* cannot be construed to mean that *every other type of transaction* is exempted from the reporting requirements of Section 16(a) of the Act. This is especially true in situations, such as the present one, where the former director's short-swing transaction comes within the proscribed purpose of Section 16(b).

In his second argument appellee contended that his short-swing transactions allegedly were not subject to Section 16(b) because, (a) the "sales" involved in such short-swing transaction "were made by him in good faith conformity with SEC Rules 16a-1 and 16a-10," and, (b) such "sales" were made in good faith reliance upon advice from his personal counsel and counsel for the issuer.

The basis for such arguments was predicated upon Section 23(a) of the Act which, in so far as is here material, provides that, "No provision of this chapter

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[20] *Securities & Exchange Commission v. Sunbeam Gold Mines Co.* (9 C.A.), 95 F. 2d 699, 701.

imposing any liability shall apply to any act done or omitted in good faith in connection with any rule or regulation of the Commission."

We have heretofore shown, however, that since appellee's "sales" were not specifically exempted under Rule 16a-1(e) this transaction could not possibly have been exempted from Section 16(b) within the contemplation of Rule 16a-10. Accordingly, the provisions of Section 23(a) of the Act were not applicable to his erroneous reliance on the Commission's rules.

Similarly, since the non-liability provision of Section 23(a) of the Act is applicable *only* to an act done in good faith reliance upon a *"rule or regulation* of the Commission," appellee's reliance upon his counsel's advice would not be covered under that statute and, indeed, would not be covered even if his reliance were based "upon the interpretative opinions commonly expressed by Commission counsel or other officials."[21]

POINT V.

Since the Commission's Rule 16b-6 is inconsistent with the express provisions and legislative purpose of Section 16(b) of the Act, its application should not be permitted in determining the amount of recoverable profits.

Appellant requested judgment against appellee in the court below in the amount of $499,706.29 basing his computations upon the difference between the net proceeds

[21]See, Securities Regulation (1951 Ed.), by Louis Loss, at page 1097. This interpretation of Section 23(a) was also cited with approval by this court in *Greene v. Dietz* (2 C.A.), 247 F. 2d 689, note 8.

of the sales and the actual acquisition cost of the shares involved. Appellee contended, on the other hand, that the maximum recoverable profits under the Commission's Rule 16b-6 amounted to $151,631.29. In view of its dismissal of the complaint the court below did not reach the issue of damages (App. 20a, note 1).

The Commission's Rule 16b-6 provides in substance that, where an insider's violation of Section 16(b) involves his acquisition of the issuer's shares through the exercise of an option granted to him more than six months prior to its exercise, the amount of profits recoverable from the insider "shall not exceed the difference between the proceeds of sale and the lowest market price of any security of the same class within six months before or after the date of sale," and, in no event shall the application of such rule "be deemed to enlarge the amount of profit which would inure to the issuer in the absence of this rule."

Although we are aware that the validity of Rule 16b-6 has previously been upheld,[22] we, nevertheless, urge this court to reconsider its prior decision because we believe, as we shall hereinafter demonstrate, that the application of the rule is inconsistent and conflicts with the express provisions and intended purposes of Section 16(b), for the following reasons:

Firstly, the application of the rule improperly limits, and in almost all instances substantially reduces, the amount of profits otherwise recoverable under the express provisions of the statute. In fact, there are many situations where the rule's application completely wipes out *all* recoverable profits entirely.

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[22] *Kornfeld v. Eaton* (2 C.A.), 327 F. 2d 263.

Secondly, the application of the rule improperly extends the express statutory period within which the violation is deemed to have occurred beyond the "less than six months" period of the actual transactions involved.

Finally, the application of the rule improperly extends the express provisions of Section 16(b) that "no such suit shall be brought more than two years after the date such profits was realized."

A. The profits recoverable.

Section 16(b) expressly provides for the recovery from the insider of "*any profit realized* by him" from his short-swing transaction.

Although the phrase, "any profit" is nowhere specifically defined in the Act, its meaning and generally accepted use is so universal as to require no further definition. The obvious meaning of "*any* profit" is "*all*" profit. And it has been held that, "In construing statutes the word 'any' is equivalent and has the force of 'every' or 'all.' "[23]

Moreover, the courts have on numerous occasions held that, in view of its legislative purpose, Section 16(b) "was intended to be thoroughgoing, to squeeze *all possible profits* out of stock transactions, and thus to establish a standard so high as to prevent any conflict between the selfish interest of a fiduciary officer, director, or stockholder and the faithful performance of his duty."[24] And, since "the statute does not allow the fiduciary to

[23]*Motor Cargo v. Board of Township Trustees*, 117 N. E. 2d 224, 227; see also, *Hamilton Fire Ins. Co. v. Cervantes*, 278 S. W. 2d 20, 24.

[24]*Smolowe v. Delendo Corp.*, *supra*, at page 239.

minimize his profits,"[25] the effectuation of its intended legislative purpose points to "only one way to prevent stock manipulations by insiders to whom confidential information is available, and that is to squeeze *every possible penny of profit* out of such transactions."[26]

It is thus quite evident from the express words of the statute itself, as well as from its underlying history,[27] that its intended purpose was to recover every last penny of any profit from the insider who violated its provisions.

While "the statute makes no distinction between stock purchased by insiders in the market and stock purchased by them under option agreements," Rule 16b-6 does in fact make such a distinction in an area "which Congress thought was most in need of regulation."[28]

Although the Commission's stated purpose in adopting Rule 16b-6 was "to avoid the surrender (by the insider) of profits which we regard as clearly attributable to (his) long term holding of the option, rather than the short-swing in the equity security,"[29] it was actually

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[25]*Gratz v. Claughton, supra*, at page 51.

[26]*Blau v. Lehman* (2 C.A.), 286 F. 2d 786 at page 791.

[27]The following colloquy occurred at the Hearings before the Committee on Banking and Currency, U. S. Senate, 73d Cong., 1st Sess., on S. Res. 84, 2d Cong., Part 15, page 6557, with respect to the purpose of Sections 16(b) as finally enacted:

> "Senator Kean: Suppose he (the insider) had to sell.
> "Mr. Corcoran: Let him get out what he put in, but give the corporation the profit."

[28]*Perlman v. Timberlake* (D.C.N.Y.) 172 F. Supp. 246 at pages 255-257.

[29]S.E.C. Release No. 4509, dated October 30, 1950, page 7, note 8.

designed to grant preferential treatment to a specially favored class of insider who was instrumental in initiating and causing his issuer to grant the options to him in the first instance.

An analysis of the Rule will demonstrate that it has no logical basis in fact and that its application tends to defeat the legislative purpose of the statute. For, under the profit-limiting provisions of the Rule an insider can violate Section 16(b) with impunity, permitting the profits from his short-swing transactions to be practically untouchable if he has a reserve of unexercised options. Moreover, in limiting the amount of profits which otherwise would be recoverable from such insider, the Rule not only "tends to stimulate" more active trading (by such insider) by reducing his chance of penalty,"[30] but it also builds into the statute an unfair discrimination which substantially eliminates him from its operation although he may have realized *all* of his short-swing profits as a result of his inside information.

B. The six-month period.

Under the express provisions of Section 16(b) a "violation" arises only when the insider has effected *both* a purchase and a sale of his issuer's shares "*within* any period of *less than* six months." By specifically limiting the statutory recovery to "any profit realized" from *such* purchase and sale, the statute clearly indicates that the computation of the recoverable profits must be confined to the "less than six months" period during which such purchase and sale occurred.

By limiting the statutory recovery of profits to "the difference between the proceeds of sale and the lowest

[30]*Smolowe v. Delendo Corp.*, *supra*, at page 238.

market price of any security of the same class within six months before or after the date of *sale,*" however, Rule 16b-6, in effect, attributes an artificial "cost" to the shares acquired by the insider's exercise of his option which is arbitrarily determined *solely* in relation to a market price within a six-month period *before or after* the date of the *sale*.

Such an artificial method for determining "cost," however, conflicts with the statutory provisions which define the "violation," for the following reasons:

Firstly, the application of this method requires that such "cost" be measured in every case by a period of time *greater than* the statutory period of "less than six months," and *outside* the period within which the actual violation occurred.

Secondly, not only does the application of this method bear no relationship to the *actual cost* of the security acquired by the insider, but it even fails *to relate* such artificial "cost" to the *security acquired* by limiting such "cost" to the lowest market price during a period of six months before or after *the date of sale*.

We have seen, however, that the computation of "profit realized" under the statute requires that its determination be directly related to the purchase itself, as well as to the sale involved. The Rule does not fulfill this requirement.

Moreover, since the insider is under no obligation to exercise his option at any time, when he does so within a period of less than six months of a sale, "it is unrealistic for purposes of computing the time within which the transactions took place to look back to a period of

time when he had no ownership in the stock and no duty to acquire it."[31]

Finally, the application of this method not only discriminates unfairly against the insider who acquires his shares in the open market, but it even fails to accord the same treatment to insiders who have been granted identical options at the same time.

In the first situation, the profits recoverable from the insider are computed on the basis of his *actual cost* of the shares purchased in the open market, while in the second situation, the insider's "cost" bears no relationship to its actual purchase price. Moreover, where the issuer's shares are acquired through exercise of options it is possible for one insider to be affected substantially differently than another under Section 16(b), although each may have acquired identical options at the same time and realized identical profits from transactions effected within the same six-month period.

Thus, for example, let us consider the case of two insiders, X and Y, each of whom was granted an identical option at the same time which is exercisable immediately at $10 per share.

Both X and Y retain their unexercised options for more than six months. During the following six months the lowest market price of the issuer's stock is $10 per share, and at the end of this period both X and Y initiate a short-swing transaction on the same day. X *sells* his issuer's stock at $20 per share, while Y *acquires* his option stock at $10 per share. During the following six months the lowest market price of the issuer's stock is $20 per share. Two days before the end of

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[31]*Perlman v. Timberlake, supra*, at page 256.

this latter six-month period X *acquires* his option stock at $10 per share, while Y *sells* his issuer's stock at $20 per share. During the next six months the lowest market price of the issuer's stock is $20 per share.

In each case, both X and Y have realized *actual* profits from their short-swing transactions of $10 per share, which, in the absence of Rule 16b-6, would be recoverable from *each* of them. Under the application of the rule, however, *nothing* is recoverable from Y, while $10 per share is recoverable from X, *although the latter has retained his unexercised option for a period of six months longer than the former.*

Since the Commission's stated purpose for the rule was to exempt that portion of the insider's short-swing profits "clearly attributable to (his) long term holding of the option," the rule completely failed to accomplish such purpose in the case of X.

C. The Rule's affect on the statute of limitations.

Under its express provisions Section 16(b) requires that suit to enforce the statutory recovery against the insider be instituted *not later than* "two years after the date such profit was *realized*." Since the statutory violation arises immediately upon the completion of the short-swing transaction, and the insider's liability for "any profit realized" becomes fixed at that point, any action to enforce such liability must be commenced within two years from *that* date.

In its application, however, Rule 16b-6 tends to destroy the very foundation of the statutory provision requiring the commencement of suit within two years "after the date *such profit was realized*" because, in its effect, the Rule makes the last day of the *six-month period subse-*

quent to the sale, rather than the date when the insider's "profit was realized," the principal factor in determining not only the extent of recoverable profits, *but whether such violation has given rise to any recoverable profits at all.*

For example, let us consider the case of the insider who acquires his option stock at $10 per share and then sells them for $20 per share less than six months thereafter. Let us further assume that the lowest market price of such stock six months *prior to* the sale was $20 per share. At this point, although the insider's statutory violation has been completed and he has realized an *actual* profit of $10 per share from the transaction, since he has not realized any "recoverable" profits within the application of Rule 16b-6, the issuer has no *actionable* cause of action under Section 16(b) *at this time.*

Now let us assume that on the very last day of the six-month period *following* the insider's sale of the shares, the market price falls to $10 per share. At this point, although the short-swing transaction was completed and the statutory violation arose *six months earlier* the application of Rule 16b-6 *now* indicates that the issuer has an actionable cause of action under Section 16(b) to recover $10 per share from the insider.

The provocative question now arises. When did the two-year statute of limitations begin to run against such claim? Did it start on the date the insider *sold* his shares giving rise to the statutory violation, or did it commence to run against the claim *six months later?* Since the issuer had no recoverable claim within the application of Rule 16b-6 when the insider sold his shares, although the express provisions of Section 16(b) gave rise to the statutory recovery at that time, could

the rule validly extend the statute of limitations for a period of six months *beyond* that provided for in the statute?

We believe that the insider would be justified in urging that the rule could not extend the statute of limitations beyond the two-year period expressed in the statute.

It is quite obvious that Rule 16b-6 is inconsistent with the limitations provisions of the statute because the application of the Rule is coupled with uncertainty and doubt which casts dark shadows against the framework of the statutory purpose.

D. Since the Rule is inconsistent with the statutory purpose, the Commission lacked the power to promulgate such Rule.

Under the express provisions of Section 16(b) Congress conferred a "limited authority" upon the Commission to exempt from its operation "any transaction or transactions * * * *not comprehended within the purpose of this subsection.*"

In construing the extent of the Commission's authority this court held that "the delegation (of such authority) serves no other than the commendable functions of relieving the statute from imposing undue hardship and giving it flexibility in administration," and that the Commission's regulations in this respect *must "be consistent with the expressed purpose of the statute."*[32]

While the Commission was granted the authority to exempt transactions involving "undue hardship," where such "hardship," nevertheless, is illusory and non-existent, the Commission's rule-making power is "actually limited"

[32]*Smolowe v. Delendo Corp., supra*, at page 240

and must be "consistent with the express purpose of the statute." Moreover, since the direct mandate of the legislative purpose of a statute cannot be ignored by the Commission, the promulgation of a Rule which purports to exempt a particular type of transaction from the operation of the statute is *not* "a matter solely within the expertise of the SEC and therefore beyond the scope of judicial review."[33]

The requirement that an insider, who acquires stock pursuant to an option which he may exercise at his election, should not engage in *sales* of such shares for a period of six months before or after such option-exercise, can hardly be considered an "undue hardship." Indeed, the very purpose of Section 16(b) contemplated the elimination of precisely such type of short-term trading by insiders whose speculative activities might well be predicated on the use of confidential information not available to the investing public.

Moreover, the opportunities for an insider to profit from his short-swing transactions are much greater where he has a reserve of stock options because he can time his sale of the issuer's shares so as to best capitalize on his inside information and yet be secure in his knowledge that his purchase price of the shares is fixed and can be no higher.

In *Greene v. Dietz, supra* (at p. 693), this court expressed "doubt as to the power of the Commission to promulgate Rule X-16b-3 inasmuch as the Rule's broad language may permit acts by insiders sought to be prevented by the Securities Exchange Act."[34]

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[33]*Greene v. Dietz, supra*, Note 12 at page 692.

[34]In September, 1952, the Commission had amended its Rule X-16b-3 to exempt from the operation of Section 16(b) stock acquired pursuant to certain types of nontransferable options.

In *Perlman v. Timberlake, supra,* the court definitively held (at pp. 256-257) that Rule X-16b-3 was *invalid* because it "is in conflict with the expressed purpose of the statute." The court went on to say that, "what started out as a rule to relieve from hardship has by constant expansion resulted in a *pro tanto* repeal of Section 16(b) with respect to a restricted option stock," and that "such repeal by implication, regulation or judicial inventiveness is not favored, especially in so important a piece of legislation which is being so vigorously enforced." The court concluded that in its promulgation of the above rule, "the Commission 'attempted to clear a narrow path of immunity through the mine field of insider temptations,'—precisely what Congress declined to do * * *, and that such attempt is beyond the power of the Commission."

Despite the Commission's apparent recognition that "an insider who exercises an option with the intention of reselling, after a short term holding, the security thereby acquired is engaged in the type of short term speculative swing which Congress intended to deter,"[35] Rule 16b-6, in effect, grants a "partial exemption" from such a transaction which is expressly designed to *limit and reduce* the amount of recoverable profits, thus facilitating the insider's evasion of the statutory purpose.

This court has stated that although "the Commission may exempt transactions," nevertheless, "it cannot reduce the liability imposed by Section 16(b)."[36]

One noted commentator has suggested that since Rule 16b-6 "minimizes damages in a transaction where liability is already established," such rule "is not only

[35] S.E.C. Release No. 4509, dated October 30, 1950, at page 5.

[36] *Rattner v. Lehman* (2 C.A.), 193 F. 2d 564, 566.

a weak palliative, and unwise, but its promulgation was without legislative authority as well."[37]

CONCLUSION.

The judgment should be reversed, with costs, and judgment entered against the appellee in the sum of $499,706.29, with interest.

New York, New York,
May 20, 1974.

Respectfully submitted,

MORRIS J. LEVY,
Attorney for Plaintiff-Appellant,
Harry Lewis.

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[37]Stock Options and the "Insider Trading" Provisions of the Securities Exchange Act, by Professor Hardee, 65 Harv. L. Rev. 997, at page 1006.

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